

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
THE LEARNER COMPANY, ET AL.)

Appearances:

For Appellants: **Terrance** L. Stinnett
Attorney at Law

Jay R. Oliff
Certified Public Accountant

For Respondent: Kendall E. Kinyon
Counsel

O P I N I O N

These appeals are made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of The Learner Company, Suan Shipping Company, Inc., and Learner Investment Company against proposed assessments of additional franchise tax in the following amounts for the years indicated:

Appeals of The Learner Company, et al.

<u>A p p e l l a n t</u>	<u>Income Year Ended</u>	<u>Proposed Assessment</u>
The Learner Company	9/30/68	\$ 12,295.04
	9/30/69	18,797.65
	9/30/70	36,250.56
	9/30/72	29,544.15
	9/30/73	12,997.47
	9/30/74	186,785.19
	9/30/75	289,597.31
Suan Shipping Company, Inc.	12/31/74	\$ 17,044.65
Learner Investment Company	2/28/70	\$ 348.36
	2/28/74	4,515.80
	2/28/75	3,285.17

Subsequent to the filing of these appeals, appellants paid the total proposed assessments of additional franchise tax issued against The Learner Company and Suan Shipping Company, Inc. Accordingly, insofar as the appeals relate to those companies, they will be treated as being from the denial of claims for refund, pursuant to section 26078 of the Revenue and Taxation Code. The appeals of Learner Investment Company retain their original status.

The Learner Company is a California corporation engaged in buying, processing and selling scrap **metals**. Its headquarters and principal offices are located in Oakland, California, and it operates salvage yards in California and Utah. Mr. Paul W. Learner is president of the company and owns 99.6 percent of its outstanding stock. The Learner Company has one wholly owned subsidiary, **Flynn-Learner**, a California corporation engaged in the scrap metal business in Hawaii.

Mr. Learner owns 100 percent of the stock of appellants Learner Investment Company and Suan Shipping Company, Inc. Until its liquidation in 1969, Mr. Learner also was the controlling stockholder of Terrylin Shipping Corporation. During the years under appeal, the operations of each of these companies were related in various ways to the scrap metal business of The Learner Company.

Appellant Learner Investment Company, incorporated under California law, owns land and improvements which generally are contiguous with The Learner Company's salvage yards. A major portion of the income

Appeals of The Learner Company, et al.

of Learner Investment Company is derived from rentals to affiliated companies.

Appellant Suan Shipping Company is a Panamanian corporation which owns and operates Liberian flag vessels. Prior to 1972 one such vessel, the M. V. Suan, was in operation: in 1972 the corporation acquired and placed into service a second Liberian flag vessel, the M. V. Terrylin. Both ships apparently are available for charter but are used primarily for carrying scrap metal on behalf of The Learner Company between California and foreign ports.

Prior to its liquidation in 1969, Terrylin Shipping Corporation operated as a ship chartering agent. Its primary chartering activity was related to The Learner Company's scrap metal shipments to Japan. It also acted as general agent for Suan Shipping Company, Inc.

Most of The Learner Company's sales of scrap metals are to customers outside California. During each of the appeal years, at least 70 percent of those sales were to customers located in Japan, and the property sold was shipped from facilities located in California. Appellants did not file Japanese income tax returns, nor did they pay any income tax to Japan during the appeal years. The Learner Company and the other appellants are represented in Japan by Hanyo Trading Company and Pacific Suppliers, Ltd., through the president of those two companies, Mr. Henry Tetsuo Osano, a Japanese citizen. The contractual relationship between appellants and Mr. Osano apparently began on April 27, 1961, when The Learner Company and Pacific Suppliers, Ltd., as represented by Mr. Osano, entered into a two-year agreement. Pursuant to the terms of that agreement, The Learner Company appointed Mr. Osano its representative and agent in Japan and agreed to allow him and his company to hold themselves forth as such. The agreement further provided that Mr. Osano was to perform the following duties on behalf of The Learner Company:

- (1) negotiate and enter into agreements for the sale or purchase of any and all commodities requested by The Learner Company, consisting primarily of scrap metals;
- (2) in connection with any contracts with customers in Japan, attend to all shipments to see that proper handling takes place; and
- (3) work out settlements with all parties in Japan on behalf of The Learner Company.

Mr. Osano was to be paid for his services entirely by commissions, and the agreement expressly provided that

Appeals of The Learner Company, et al.

it was terminable by either party upon sixty days written notice by registered mail.

The above contract has been extended by oral agreement of the parties since its expiration date in 1962. Pursuant to its terms, throughout the appeal years Mr. Osano continued to negotiate and execute on behalf of The Learner Company contracts for the purchase and sale of scrap metals in Japan. In this connection, he kept The Learner Company's Oakland office advised periodically, via cable, of the progress of his negotiations, of prevailing market conditions, prices being offered, and of sales by competitors. Ultimately, he established the sales prices, within ranges set by The Learner Company, and worked out various other terms of sales contracts. As authorized under the agreement, he also oversaw The Learner Company's scrap metal shipments to Japan and negotiated or compromised disputes which developed with Japanese customers.

Pacific Suppliers, Ltd. and Hanyo Trading Company have offices in Tokyo, Japan, and Honolulu, Hawaii. Mr. Osano hires his own employees to assist him in his duties as agent for The Learner Company and other foreign principals trading in Japan. In correspondence which he issues on behalf of The Learner Company, Mr. Osano identifies himself as that company's representative. It appears that the only Tokyo office expense borne by The Learner Company is the cost of the cables transmitted from Japan to The Learner Company by Mr. Osano and his assistants.

During the appeal years, Paul W. Learner, president of The Learner Company, and Ernest E. Bridgewater, its executive vice president, made occasional trips to Japan. Their trips occurred once or

1/ The record does not indicate when Hanyo Trading Company entered the factual picture. It appears, however, that during the appeal years it was the operative agent of The Learner Company in Japan, as represented by its president, Mr. Osano. For purposes of this opinion, Mr. Osano will at times be referred to as appellants' representative in Japan, although we are fully aware that the contract in question was actually between The Learner Company and Mr. Osano's wholly owned corporation, Pacific Suppliers, Ltd.

Appeals of The Learner Company, et al.

twice a year and were generally of one to three weeks in duration. During their stays in Japan, Messrs. Learner and Bridgewater visited a number of trading companies and steel consumers, including both existing and potential customers of The Learner Company. The stated purposes of those trips were to solicit sales of scrap metal and to discuss various shipping problems. In the earlier appeal years, the visits also involved negotiations for the construction in Japan of the M. V. Terrylin, appellant Suan Shipping Company, Inc.'s second vessel, which was placed into service in 1972.

For each appeal year, appellants filed California franchise tax returns on a separate accounting basis. In computing its income from California sources, The Learner Company treated all sales made to customers located in foreign countries and states other than California as sales without the state. Upon examination of those separate returns, respondent determined that The Learner Company, Learner Investment Company, Suan Shipping Company, Inc., Flynn-Learner and Terrylin Shipping Corporation were all engaged in a single unitary business. Accordingly, their income from California sources was recomputed by use of a combined report and a three-factor (property, payroll and sales) apportionment formula. In computing the sales factor of the apportionment formula, respondent assigned to California those sales made by The Learner Company in Japan and other foreign countries. The assignment of foreign sales to California was based upon the provisions of sections 25122 and 25135 of the Revenue and Taxation Code and respondent's regulations issued thereunder. In determining the factors of the various affiliated corporations, respondent included those of Suan Shipping Company, Inc. on a "voyage day" basis. (Cal. Admin. Code, tit. 18, reg. 25101, subd. (b).) For one of the appeal years, income year 1974, respondent issued a direct deficiency assessment against Suan Shipping Company, Inc.

At the protest level, appellants objected to respondent's determination of their unitary status and to the factors used in the apportionment formula. They now appear to concede that the affiliated Learner companies constitute a unitary business. Accordingly, pursuant to the provisions of section 25101 of the Revenue and Taxation Code, their income from California sources is to be determined pursuant to the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), which is contained

Appeals of The Learner Company, et al.

in sections 25120-25139 of the Revenue and Taxation Code. Although appellants no longer question the propriety of applying an apportionment formula to determine that portion of their net income which is subject to tax in California, they contend that the formula used by respondent fails to do this. The issues for decision, therefore, concern the composition of the three factors used by respondent in computing appellants' income from California sources, and the direct assessment of franchise tax against Suan Shipping Company, Inc. for the income year 1974.

- I. WHETHER, FOR PURPOSES OF COMPUTING THE SALES FACTOR OF THE APPORTIONMENT FORMULA, RESPONDENT PROPERLY ASSIGNED TO CALIFORNIA ALL SALES MADE BY OR ON BEHALF OF THE LEARNER COMPANY TO CUSTOMERS IN JAPAN.

'Generally speaking, UDITPA requires that a taxpayer's business income be apportioned to this state by multiplying the income by a fraction, the numerator, of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three. (Rev. & Tax. Code, § 25128.) Section 25134 of the Revenue and Taxation Code defines the sales factor as follows:

The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year.

The rules for determining whether sales of tangible personal property are in this state are set forth in section 25135 of the Revenue and Taxation Code as follows:

Sales of tangible personal property are in this state if:

(a) The property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) The property is shipped from an office, store, warehouse, factory, or other

Appeals of The Learner Company., et al.

place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser. (Emphasis added.)

As it is used in the apportionment provisions, the term "state" is defined to include any foreign country or political subdivision thereof. (Rev. & Tax. Code, § 25120, subd. (f).) The purpose of subdivision (b)(2) of section 25135, commonly termed the "throwback rule," is to prevent the apportionment of sales under the usual "destination" rule to states or countries in which the taxpayer is not doing business, thereby preventing the apportionment of income to a state or country which is without jurisdiction to tax such income. (Keesling and Warren, California's Uniform Division of Income for Tax Purposes Act (Part II), 15 U.C.L.A. L. Rev. 655, 672 (1968).)

Under UDITPA, whether a California taxpayer is taxable outside of California is determined pursuant to the provisions of section 25122 of the Revenue and Taxation Code, which reads as follows:

For purposes of allocation and apportionment of income under this act, a taxpayer is taxable in another state if (a) in that state it is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (b) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

With respect to subdivision (b) of this section, respondent's regulations provide:

The second test, that of Section 25122 (b), applies if the taxpayer's business activity is sufficient to give the state jurisdiction to impose a net income tax by reason of such business activity under the Constitution and statutes of the United States. Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provisions of Public Law 86-272, 15 U.S.C.A. §§ 381-385. In the case of any "state" as defined in Section 25120(f), other than a state of the United

Appeals of The Learner Company, et al.

States or political subdivision of such state, the determination of whether such "state" has jurisdiction to subject the taxpayer to a net income tax shall be made as though the jurisdictional standards applicable to a state of the United States applied in that "state.", If jurisdiction is otherwise present, such "state" is not considered as without jurisdiction by reason of the provisions of a treaty between that state and the United States. (Cal. Admin. Code, ~~15~~ 18, reg. 25122, subd. (c) (Art. 2.5).) ^{2/}

Applying the above rules in the instant case, respondent determined that The Learner Company's sales of scrap metal shipped from California to customers in Japan and other foreign countries should be treated as California sales and included in the numerator of the sales factor since, under the jurisdictional standards applicable in the case of another state of the United States, The Learner Company was not subject to a net income tax in Japan or in the other foreign countries in which its customers were located.

Appellants apparently do not contest the assignment to California of The Learner Company's sales to purchasers in foreign countries other than Japan. Although they **concededly** paid no income tax to Japan during the appeal years, they nevertheless contend that the business activities of The Learner Company and its representatives in Japan were sufficient to give that country jurisdiction, hypothetically, to impose an income tax under United States constitutional and statutory standards. Under those circumstances, appellants urge, the sales to Japanese customers should not have been "thrown back" to California, the state from which the goods were shipped. Specifically, it is appellants' position that during the appeal years the statutory immunity from tax which is afforded by the provisions of Public Law 86-272 (15 U.S.C.A. §§ 381-384) to taxpayers carrying on minimum business activities in sister states

^{2/} Respondent's regulation 25122, subd. (c) (Art. 2), applicable for income years beginning prior to December 31, 1972, and ending after the effective date of the regulations in Article 2.5, reads substantially the same as this provision.

Appeals of The Learner Company, et al.

would not have been available to The Learner Company in Japan, if the same standards were applicable there. Since appellants herein have not **challenged** either the constitutionality of the "throwback rule,"^{3/} or the applicability of Public Law 86-272 standards to foreign commerce, we shall confine our discussion to their contention that the "throwback rule" was improperly applied in this case.

By its enactment in 1959 of Public Law 86-272 (73 Stat. 555, 15 U.S.C.A. § 381), Congress placed certain limitations on the power of a state to impose a net income tax on income derived by an out-of-state taxpayer from interstate commerce. Subdivision (a) of section 381 of the codified law provides, in relevant part:

No State, . . . shall have power to impose, . . . a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are . . . the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State: . . .

In determining whether there is jurisdiction to tax, the courts and this board have strictly limited the statutory immunity provided by Public Law 86-272 with respect to employee activity of the out-of-state seller to solicitation of orders or activities incidental thereto. (See, e.g., Miles Laboratories, Inc. v. Oregon Department of Revenue, 274 Ore. 395 [546 P.2d 1081] (1976); Iron Fireman Mfg. Co. v. State Tax Commission, 251 Ore.

^{3/} It should be noted that the constitutionality of the "throwback rule" was recently upheld by the California Court of Appeal in Hoffman-La Roche, Inc. v. Franchise Tax Board, 101 Cal. App. 3d 691 (Jan. 31, 1980). On April 10, 1980, the taxpayer's petition for hearing in the California Supreme Court was denied.

Appeals of The Learner Company, et al.

227 [445 P.2d 126) (1968); Appeal of Riblet Tramway, Cal. St. Bd. of Equal., Dec. 12, 1967.) The maintenance of a sales office-by the out-of-state seller in the taxing state, staffed by the seller's employees, clearly exceeds solicitation and is thus outside the statutory protection of Public Law 86-272. (Appeal of Schmid Brothers, Inc., Cal. St. Bd. of Equal., May 21, 1980; Appeals of CITC Industries, Inc. and Bob Wolf Associates, Inc., Cal. St. Bd. of Equal., June 28, 1979.)

Where the out-of-state seller uses independent contractors, rather than its own employees, to consummate sales in the taxing state, a greater degree of activity may **be engaged** in by such contractors without causing the out-of-state seller to lose its immunity under Public Law 86-272. In this regard, subdivisions (c) and (d) of section 381 (15 U.S.C.A. § 381) provide:

(c) For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance, of an office **in such State by one or more independent contractors** whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

(d) For purposes of this section--

(1) the term "independent contractor" means a commission agent, broker, or **other independent contractor who is engaged in** selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as **such** in the regular course of his business activities; and

(2) the term "representative" does not include an independent contractor.

As can be seen, under **these provisions** an independent contractor cannot 'only solicit sales but is also permitted to make sales and to maintain an office in the

Appeals of The Learner Company, et al.

taxing state without destroying his out-of-state principal's jurisdictional immunity from tax on the income derived from such sales.

Obviously, the taxing power of the country of Japan is not restricted in any way by the provisions of Public Law 86-272. That law **becomes** pertinent, however, for purposes of determining whether sales in Japan by a company engaged in a unitary business which is subject to tax in California are to be included in the California numerator of the sales factor. Under respondent's regulations, the determination of whether a foreign country has jurisdiction to subject the taxpayer to a net income tax is made as though the jurisdictional standards applicable to a state of the United States applied in that foreign country. (Cal. Admin. Code, tit. 18, reg. 25122, subd. (c).) Accordingly, in the instant case it is necessary to determine whether The Learner Company's activities in Japan during the appeal years were sufficient to give Japan jurisdiction to impose a net income tax under the jurisdictional **standards of the United States Constitution** and Public Law 86-272, whether or not such a tax was in fact imposed.

Appellants first contend that the activities of Mr. Osano, as representative of The Learner Company in Japan, met or exceeded the minimum standards set forth in Public Law 86-272, giving The Learner Company sufficient nexus with Japan to sustain that country's imposition of a net income tax on the income derived by The Learner Company from its sales in Japan. There can be little doubt that if Mr. Osano were deemed to be an employee of The Learner Company, his sales activity in Japan would exceed Public Law 86-272's "solicitation" standard, since he maintained an office in Japan and actually executed sales contracts on behalf of The Learner Company. Conversely, if Mr. Osano were an independent contractor, those same acts would not cause The Learner Company to lose its immunity from tax in Japan under Public Law 86-272 standards.

Respondent contends that **the** contractual relationship between Mr. Osano and The Learner Company was that of independent contractor and principal. **Appellants** disagree. They stated early in these appeal proceedings that Mr. Osano was not an employee of The Learner Company; they later characterized him as neither an employee nor an independent contractor, but as something somewhere between those two; finally, they **urge** that if the choice is between Mr. Osano's being an

Appeals of The Learner Company, et al.

employee and an independent contractor, he was an employee during the years in question. In ascertaining whether or not Public Law 86-272 standards have been exceeded, it becomes essential to first determine exactly what the business relationship was between The Learner Company and Mr. Osano.

As noted earlier, an "independent contractor" is defined, for purposes of Public Law 86-272, as "a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting **orders** for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities." (15 U.S.C.A. § 381, subd. (d)(1).) This definition has been criticized on the ground that it uses the term to be defined as part of the definition (see *Beaman*, *Paying Taxes to Other States* (1963) p. 6.23), and it is therefore necessary to look to common law rules in order to determine whether Mr. Osano was an independent contractor.

Those rules were summarized by the California Supreme Court in *Empire Star Mines Co. v. California Employment Commission*, 28 Cal. 2d 33 [168 P.2d 6861 (1946)] as follows:

In determining whether one who performs services for another is an employee or an independent contractor, the most important factor is the right to control the manner and means of accomplishing the result desired. If the employer has the authority to exercise complete control, whether or not that right is exercised with respect to all details, an employer-employee relationship exists. Strong evidence in support of an employment relationship is the right to discharge at will, without cause. [Citations.] Other factors to be taken into consideration are (a) whether or not the one performing services is engaged in a distinct occupation or business; (b) the kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the principal or by a specialist without supervision; (c) the skill required in the particular occupation; (d) whether the principal or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work; (e) the length of time for which the services are to

Appeals of The Learner Company, et al.

be performed; (f) the method of payment, whether by the time or by the job; (g) whether or not the work is a part of the regular business of the principal; and (h) whether or not the parties believe they are creating the relationship of employer-employee. (Rest., Agency, § 220; Cal. Ann. § 220.) (28 Cal. 2d at pp. 43-44.)

(See also Anglim v. Empire Star Mines Co., 129 F.2d 914 (9th Cir. 1942).) If it is otherwise determined that a person performing services is an independent contractor, that status will not be lost by his principal's retention of broad general powers of supervision and control as to the results of the work, so as to insure satisfactory performance of the independent contract. (McDonald v. Shell Oil Co., 44 Cal. 2d 785 (285 P.2d 902) (1955); Appeal of Cagney Productions, Inc., Cal. St. Bd. of Equal., April 21, 1959.)

Applying these principles here, we note that under the terms of the agreement between The Learner Company and Pacific Suppliers, Ltd., as represented by Mr. Osano, The Learner Company was not authorized to control, nor did it in fact exercise control, **over** the means or methods by which Mr. Osano and his employees conducted the operation of their offices in Tokyo and Honolulu. Although The Learner Company set certain limits on prices and other terms of the contracts negotiated by Mr. Osano, it did not control the manner in which the negotiations were carried out. Mr. Osano maintained his own company's office in Tokyo. He hired the company's employees, determined their work schedules and what duties would be performed by them, and provided all office supplies. Clearly, Mr. Osano and his corporations operated a business separate and apart from The Learner Company, one requiring special expertise, fluency in the Japanese language, and familiarity with Japanese cultural and **business** traditions. The Learner Company paid Mr. Osano entirely on a commission basis, and the success and profitability of his independent business depended upon his own efforts and the good will he was able to establish and maintain among the Japanese business people with whom he dealt. Although the original two-year contract between Pacific Suppliers, Ltd. and The Learner Company provided that it could **be terminated** by either party upon sixty days written notice, it has in fact been orally renewed and the business relationship has continued for many years. We believe all of these facts establish that Mr. Osano was an

Appeals of The Learner Company, et al.

independent contractor performing services on behalf of The Learner Company, and the broad general powers of supervision exercised by The Learner Company were not inconsistent with that status. Furthermore, Mr. Osano qualifies as an independent contractor under the definition contained in Public Law 86-272, since he holds himself out as being engaged in the business of selling and soliciting orders for the sale of tangible personal property, and he performs such services for principals other than The Learner Company.

Appellants next contend that even if it were determined that Mr. Osano was an independent contractor, the activities which he performed in Japan on behalf of The Learner Company exceeded those limited activities in which an independent contractor may engage under Public Law 86-272 standards without destroying the immunity from tax otherwise afforded his out-of-state principal. For the reasons stated hereafter, we cannot agree.

As noted earlier, Public Law 86-272 expressly allows the independent contractor not only to solicit sales in the taxing state on behalf of his out-of-state principal, but also to maintain an office in that state and to make sales, without exposing his principal to tax. Whether the independent contractor can conduct even more extensive activities than those mentioned and still preserve his out-of-state principal's Public Law 86-272 immunity has been a subject of speculation by legal writers (see, e.g., Beaman, *supra*, pp. 6.20-6.23 and Lohr-Schmidt, Developing Jurisdictional Standards for State Taxation of Multistate Corporate Net Income, 22 *Hastings L.J.* 1035, 1088-93 (1971)); however, there is no case law directly in point.

It has been settled law in California for many years that for tax jurisdictional purposes and for purposes of determining the source of income, the business activities of an independent contractor will not be equated with the business activities of his principal. (See Irvine Co. v. McCoolgan, 26 Cal. 2d 160 [157 P.2d 847] (1945).) In pre-UDITPA decisions, this

4/ The Irvine Co. case was decided under section 10 of the Bank and Corporation Franchise Tax Act (an early predecessor of present section 25101 of the Revenue and (Continued on next page.)

Appeals of The Learner Company, et al.

board has concluded that sales solicited outside California by independent contractors acting on behalf of a California vendor cannot be treated as out-of-state sales in computing the sales factor of the apportionment formula. (Appeal of Smith Oil Tool Co., Cal. St. Bd. of Equal., Sept. 20, 1962; Appeal of Cagney Productions, Inc., supra.) The tax policy behind these decisions is that a sale of goods by an independent contractor constitutes a part of the independent contractor's own business, rather than the business of the individual or corporation whose products he sells. The state in which the sale is made has jurisdiction to tax the independent contractor's profits from the sales, and that state is therefore being paid for the protection it affords the only activity occurring within its borders. The same reasoning serves as a basis for the policy set out in Public Law 86-272, which permits the out-of-state seller to have the independent contractor do more than it allows the seller's employees to do without incurring tax liability. (See **Beaman**, supra, p. 6.21.)

Public Law 86-272 was enacted in 1959 in an effort to limit the power of the various states to tax income derived from interstate commerce. Although **Congress thereby** carved out a specific area of immunity from state taxation, we find nothing in that law's legislative history to indicate any congressional intent to change prior state law regarding the tax effect of a corporation's utilization of independent contractors to consummate its sales in other states, provided such independent contractors otherwise come within the definition contained in Public Law 86-272. (See generally S. Hep. No. 658, 86th Cong. 1st Sess., reprinted in (1959) U.S. Code Cong. & Ad. News 2548-2561.) In fact, we believe it would be inconsistent with the whole restrictive purpose of that federal law to construe it in a manner which would make the selling corporation

4/ (Continued)

Taxation Code), when it was phrased in terms of "doing business" rather than "source of income." We have held, however, that the same rule applies in determining whether a **taxpayer** derives income from sources within and without California, making its income subject to formula apportionment; (Appeal of Great Western Cordage, Inc., Cal. St. Bd. of Equal., April 22, 1948.)

Appeals of The Learner Company, et al.

more vulnerable to state taxation after the enactment of Public Law 86-272 than it was, under pre-existing law. With these thoughts in mind, **we** conclude that all of the business activities conducted by Mr. Osano as an independent contractor performing services on behalf of The Learner Company and others in Japan were within the scope of activities allowable under the provisions of Public Law 86-272. **Accordingly**, Mr. Osano's sales activity on behalf of The Learner Company would not have caused the income from **such sales to be subject to tax in Japan**, under Public Law 86-272 jurisdictional standards, and respondent properly treated The Learner Company's sales in Japan as sales attributable to California.

Alternatively, appellants argue 'that during the appeal **years** the activities in Japan of Paul W. Learner and Ernest E. Bridgewater, president and **executive vice president, respectively**, of The Learner Company, exceeded the scope of "solicitation", by employees which is permissible under Public Law 86-272 standards, thereby causing The Learner Company to lose its immunity from tax in Japan if those same federal standards were applicable in **that** country. They base this contention on the fact that **Messrs. Learner and Bridgewater** each typically made an annual trip to Japan. On those trips, of one to three weeks in duration, they allegedly visited Japanese trading companies and steel **consumers**, discussed all manner of shipping and collection problems, and solicited sales of scrap metals. Respondent determined, and appellants do not deny, that most of the activities of the two chief executive officers in Japan related to the business of Suan Shipping Company, Inc., rather than to that of The Learner Company. Appellants nevertheless contend that those activities which Messrs. Learner and Bridgewater did engage in on behalf of The Learner Company in Japan exceeded **mere solicitation of sales under the jurisdictional standards of Public Law 86-272**.

Appellants have not alleged that any sales of scrap metal were actually consummated by Messrs. Learner and Bridgewater during their trips to Japan. In our opinion, the infrequent visits of two of The Learner Company's top executives to Japan can best be characterized as good will or public relations missions, rather than sales trips. We have great difficulty equating their brief annual visits to Japan with any type of regular and substantial sales activity which would give that country hypothetical jurisdiction to tax under

Appeals of The Learner Company, et al.

traditional due process standards. Certainly, we cannot **construe** their activities during those visits as constituting employee business activity in excess of "solicitation," under the jurisdictional standards of Public Law 86-272.

For the above reasons, we conclude that in **computing** the sales factor of the apportionment formula, respondent properly assigned to California all of the sales made by or on behalf of The Learner Company to customers in Japan.

II. WHETHER, IN COMPUTING THE APPORTIONMENT FORMULA, RESPONDENT ERRED IN INCLUDING FACTORS ATTRIBUTABLE TO **SUAN** SHIPPING COMPANY, INC.

As noted earlier, Suan Shipping Company, Inc. (Suan) is a Panamanian corporation which is wholly owned by Mr. Paul W. Learner, president and principal stockholder of The Learner Company. Suan owns and operates Liberian flag vessels which are available for charter but are used primarily for carrying scrap metal shipments on behalf of The Learner Company. We do not believe that it can be seriously argued that, under well established standards, Suan is not an integral part of the unitary business conducted by the other affiliated Learner companies. For reasons hereafter stated, however, appellants nevertheless object to any inclusion of factors attributable to Suan in the apportionment formula used to determine the percentage of appellants' combined unitary income which was to be apportioned to California for the years in question.

Initially, appellants contend that **by including** Suan factors in the apportionment formula, respondent has imposed a **net income** tax on a foreign-based corporation engaged in foreign commerce, thereby placing an impermissible burden upon foreign commerce in violation of the commerce clause of the United States Constitution. This argument disregards the operative effect of using the formula method in computing the taxable income of a unitary business. Once it is determined that a corporate taxpayer is engaged in a unitary business which is deriving income from sources within and without the taxing state, that state's application of a reasonable apportionment formula does not result in the taxation of extraterritorial values, but rather constitutes an attempt to estimate that portion of the total apportionable income of the combined unitary

Appeals of **The** Learner Company, et al.

operation which is reasonably attributable to local activities carried out in **the taxing jurisdiction.**

Constitutional attacks against the inclusion of income derived from foreign sources in the **preapportionment** tax base have been notably unsuccessful. As early as 1924, the United States Supreme Court approved New York's imposition of an apportioned franchise tax on a British corporation which manufactured ale in Great Britain and sold a portion of it in New York. (Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 [69 L. Ed. 282] (1924).) The constitutional validity of including foreign source income in the apportionable tax base was reaffirmed by the Supreme Court as recently as March 19, 1980, in Mobil Oil Corporation v. Commissioner of Taxes of Vermont, -- U.S. -- (63 L. Ed. 2d 510] (1980). Under the facts of that case, the Court determined that the State of Vermont's inclusion in the **preapportionment** tax base of dividend income received by Mobil Oil, a **New York** corporation, from its subsidiaries and affiliates doing business abroad did not violate either the due process clause or the commerce clause of the United States Constitution. This conclusion appears to have turned on Mobil Oil's failure to establish that the foreign operations of its subsidiaries and affiliates **were** unrelated to its integrated unitary petroleum enterprise, a portion of which was conducted in Vermont. Applying the same **principles** in the instant case, we must conclude that appellants' initial commerce clause argument is totally without merit.

Appellants next urge that respondent's inclusion of Suan's income in the apportionment formula violated the commerce clause of the federal Constitution in another way. They argue that by its enactment of section 954 of the Internal Revenue Code of 1954, Congress exercised its exclusive constitutional power to regulate foreign **commerce**, thereby demonstrating an intent that income of the type covered by that section should be exempt from all tax. During the years in question, section 954(b)(2) provided that, for certain purposes under the federal income tax law, a foreign based company's income did not include income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, **or** the performance, of services directly related to the use of any such aircraft or vessel. We see no need to go into a discussion of whether or not this provision would have any relevance under the facts

Appeals of The Learner Company, et al.

of this case since, unless specifically made applicable to the states, any congressional or treaty restrictions placed upon the imposition of a federal income tax do not limit the right of a state to impose an apportioned tax on net income. As the United States Supreme Court observed recently in the Mobil Oil case, cited above:

Concurrent federal and state taxation of income, of course, is a well-established norm. Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States. (63 L. Ed. 2d at p. 528.)'

Furthermore, as has been pointed out earlier, the apportioned tax in question in the instant case is not a tax on foreign source income, but rather a tax on that portion of the unitary business income of the Learner group which is reasonably attributable to its business activity in California.

We also summarily reject appellants' attempts to show by means of separate accounting that inclusion of the Suan factors in the apportionment formula leads to a disproportionate amount of Suan's income being attributed to California. It is well settled that separate accounting figures cannot be used to impeach the results of formula apportionment, once it is determined that a unitary business exists, as is the case here. (See Butler Bros. v. McColgan, 17 Cal. 2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L. Ed. 991] (1942); John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214 [238 P.2d 569] (1951), app. dismissed, 343 U.S. 939 [96 L. Ed. 1345] (1952).)

Finally, appellants contend that the provisions of section 24320 of the California Revenue and Taxation Code prohibited respondent from including the income of Suan Shipping Company, Inc. in the apportionment formula used to determine what portion of the Learner group's business income was to be attributed to California. That section, which was added to the Revenue and Taxation Code in 1969, reads as follows:

Income derived from the operation of aircraft or a ship or ships by a corporation organized under the laws of a foreign country shall not be included in gross income, and shall be exempt from the taxes imposed by this part if:

Appeals of The Learner Company, et al.

(a) The aircraft are registered or the ships are documented under the laws of the foreign country;

(b) The income of the corporation is exempt from national income taxes by reason of a treaty or agreement between such foreign country and the United States which provides for an equivalent exemption to corporations organized in the United States; and

(c) Units of government (other than at the national level) within such foreign country do not impose a tax upon corporations organized in the United States with respect to income derived from the operation of aircraft registered or ships documented under the laws of the United States. (Stats. 1969, ch. 1191, p. 2321-2322.)

In a letter dated August 8, 1969, to then Assembly Speaker Robert Monagan, Assemblyman Pete Wilson, who was at that time a member of the Assembly Committee on Revenue and Taxation, clarified the objectives of this legislation **and, the requirements for exemption under** section 24320 [Senate Bill 1285 of the 1969 Regular Session] as follows:

Dear Mr. Speaker: The following explanation is offered to make clear the intent of the Legislature in enacting Senate Bill 1285 of the 1969 Regular Session by Senator Burgener.

S.B. 1285 is a bill to secure for American-based sea and air carriers operating in foreign lands exemption from foreign provincial (rather than national) taxation of income derived by such carriers from their operation in foreign **lands.**

To secure this exemption for American carriers, the bill extends a reciprocal exemption from the California Bank and Corporation Tax to income earned by foreign carriers from operation within California, provided that certain specified conditions exist. One of the conditions is that the national government of the foreign carrier and the United States have entered into a **tax treaty**, granting

Appeals of The Learner Company, et al.

reciprocal exemption from their respective national income tax to the carriers of the other nation.

Therefore the exemption from the California Bank and Corporation Tax proposed in this bill would not be available to carriers of nations with whom the United States has no such treaty. ... (4 Assem. J. (1969 Reg. Sess.) p. 8249.)

We agree with respondent that in order for income to be exempt from tax under section 24320 of the Revenue and Taxation Code, all of the qualifying conditions specified in that section must be met. Insofar as is applicable here, the first such requirement is that the income in question **must be derived from** the operation of a ship or ships by a corporation organized under the laws of a foreign country. It is undisputed that the income of Suan Shipping Company, Inc., a Panamanian corporation, meets this initial statutory condition.

The second requirement for the exemption, set forth in subdivision (a) of section 24320, is that the ship be documented "under the laws of the foreign country." (Emphasis added.) Respondent **argues** that the use of the definite article "the," as opposed to an indefinite "a," before the noun "foreign country" presents yet another qualifying condition, i.e., that the corporation and the ship must meet the dual test of nationality and documentation before the section 24320 exemption **applies**. Respondent contends that support for its position is to be found in Revenue Ruling 75-459 (1975-2 Cum. Bull. 289, revoking Rev. Rul. 73-350, 1973-2 Cum. Bull. 251), an Internal Revenue Service interpretation of section 883 of the Internal Revenue Code of 1954. That section provides a federal tax exemption to a foreign corporation deriving earnings **from** the operation of ships documented under the laws of a foreign country which grants an equivalent exemption **to** United States citizens and corporations. Appellant urges that respondent's position, if adopted, would defeat the purposes for which section 24320 of the Revenue and Taxation Code was enacted.

We reserve decision on this issue for the proper case, in view of our belief that a third condition for exemption under section 24320 has not been met in the instant appeals. That requirement, set forth in subdivision (b) of the section, is that the income of

Appeals of The Learner Company, et al.

the foreign corporation'be exempt from national income taxes by reason of a treaty or agreement between the foreign country and the United States which provides for an equivalent exemption to United States corporations. We believe that the only reasonable construction of section 24320 is one which requires such a treaty or agreement between the United States and the foreign country of documentation, in this case, Liberia. The income in question is derived as a direct result of the operation of ships flying the flag of that country, and the "equivalent exemption" must exist between the United States and that country if the quid pro quo theme of the statute is ~~to be~~ implemented.

No such qualifying treaty or agreement exists between the United States and Liberia. Although we understand that the shipping income of Liberian companies is unilaterally exempted from the **United States** tax base by reason of section 883 of the Internal Revenue Code, because Liberia unilaterally exempts from its income tax the income of all foreign owned ships engaged in foreign commerce, this is not sufficient to satisfy the requirements of section 24320 of the Revenue and Taxation Code. The latter section, unlike the federal income tax provision, clearly conditions the availability of the exemption from tax in California on the existence of a formal treaty or agreement between the United States and **the foreign country in question**. Unilateral accommodations will not suffice. Under the circumstances, section 24320 is inapplicable in the instant case, and it therefore presents no barrier to inclusion of the income of Suan Shipping Company, Inc. in the apportionment formula used by respondent to determine appellants' California franchise tax liability.

III. WHETHER THE DIRECT ASSESSMENT OF TAX
ISSUED AGAINST SUAN SHIPPING COMPANY,
INC. FOR THE INCOME YEAR 1974 WAS PROPER.

Generally speaking, the apportionment of income of a unitary business carried on by separate corporations consists of two steps. First, it is necessary to determine by apportionment formula that amount of the total net income of the corporate group which is attributable to California sources. If more than one of the corporations is doing business in California, a second step is then undertaken in order to divide the aggregate California net income and the resulting California franchise tax liability among those corporations doing

Appeals of The Learner Company, et al.

business in California. (See Keesling and Warren, The Unitary Concept in the Allocation of Income, 12 Hastings L.J. 42, 59 (1960).)

We have already concluded that in all of the years involved in these appeals, respondent properly included the factors of Suan Shipping Company, Inc. in **computing** the combined unitary income of the related group of Learner corporations. In each year respondent then completed the first step of the apportionment process, as outlined **in the preceding paragraph**, by **determining by formula apportionment what portion of the group's unitary income** was subject to tax in California. For all income years other than 1974, respondent then carried out the second step mentioned above, further apportioning the aggregate California net income between The Learner Company and Learner Investment Company and issuing direct assessments of franchise tax accordingly. For one income year only, 1974, respondent also issued a direct assessment against Suan Shipping Company, Inc. We confess to being puzzled by this distinct treatment of Suan for that one year, in view of the fact that the Learner group's business operations were apparently carried on, in that year in the same manner as in every other appeal year. Our only concern here, however, is whether that direct assessment can be sustained.

The assessment against Suan Shipping Company, Inc. for the income year 1974 presumably was based upon respondent's determination that Suan was not only a part of the Learner unitary group, but that it was also doing business in this state in that year. "Doing business" is defined in the Bank and Corporation Tax Law to mean "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit," (Rev. & Tax. Code, § 23101.) In support of its determination with respect to 1974, which carries with it a presumption of correctness (Appeal of Halliburton Oil Well Cementing Co., Cal. St. Bd. of Equal., April 20, 1955), respondent relies on the following undisputed facts:

(1) Suan Shipping Company, Inc. was wholly owned by Mr. Paul W. Learner, a resident of California; (2) it owned two Liberian flag vessels which were used primarily in carrying scrap metal shipments between California ports, principally the Port of Oakland, and foreign ports; (3) although Suan was a Panamanian corporation, its only representative in Panama was a lifetime agent appointed on formation of the corporation; (4) Suan's corporate officers, directors and shareholders were all residents of California; (5) the meetings of Suan's board of

Appeals of The Learner Company, et al.

directors and its shareholders were held. in California:
(6) all records of that corporation, including books of account, were maintained in this state; and (7) charters for the services of Suan's two Liberian flag vessels were arranged by personnel of the affiliated Learner companies located in California.

The above facts **do** indicate that Suan Shipping Company, Inc. had substantial contacts with the State of California in 1974. Furthermore, appellants have not argued that Suan was not doing business in California in that year. They **have based** their contention that the direct assessment was improper primarily on the applicability of Revenue and Taxation Code section 24320 to exempt Suan's income from taxation in California. In **view** of our decision that section 24320 is not applicable in the instant case, we must conclude that appellants have failed to establish error in respondent's direct assessment against Suan Shipping Company, Inc. for the income year 1974.

On the basis of the foregoing analysis, we hold that respondent's action in these matters must be sustained in all respects.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,



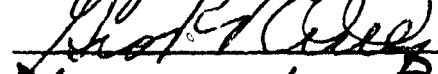

Appeals of The Learner Company, et al.

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of The Learner Company and Suan Shipping Company, Inc. for refund of franchise tax in the following amounts for the years indicated:

<u>Appellant,</u>	<u>Income Year Ended</u>	<u>Refund Claimed</u>
The Learner Company	9/30/68	\$ 12,295.04
	9/30/69	18,797.65
	9/30/70	36,250.56
	9/30/72	29,544.15
	9/30/73	12,997.47
	9/30/74	186,785.19
	9/30/75	289,597.31
Suan Shipping Company, Inc.	12/31/74	\$ 17,044.65

be and the same is hereby sustained. It is further ordered, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Learner Investment Company against proposed assessments of additional franchise tax in the amounts of \$348.36, \$4,515.80 and \$3,285.17 for the income years ended February 28, 1970, February 28, 1974, and February 25, 1975, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 30th day of September, 1980, by the State Board of Equalization.


_____, Chairman

_____, Member

_____, Member

_____, Member
_____, Member